

Report of the Committee on Energy Development—Federal Lands

The year 1987 saw a number of developments which will affect energy exploration and production on federal lands for many years to come. These developments generally fall into two categories: (1) decisions respecting which lands will be subjected in the future to oil and gas leasing and the procedures to be applied in such leasing and (2) how oil and gas produced from federal lands will be valued for purposes of determining royalties.

I. OIL AND GAS LEASING DEVELOPMENTS

A. Onshore Leasing Reform

In the closing days of its 1987 session, Congress enacted legislation to amend the procedures utilized to lease onshore federal lands. The new act, adopted as part of the Omnibus Budget Reconciliation Act,¹ will markedly affect the procedures utilized to award leases of lands not previously subject to competitive bidding.

1. Background

Prior to 1920, oil and gas resources on public lands had been made available as placer deposits under the mining laws of 1872, as amended in 1897.² This approach proved unsuitable, primarily because it contemplated a permanent disposition of the lands by fee conveyance. The procedure was changed to a leasing format with the passage of the Mineral Lands Leasing Act of 1920 (MLLA).³

In the MLLA, Congress required that proven and unproven lands be leased under separate procedures, with the proven lands to be leased competitively. Proven lands were not easy to define either on the basis of an arbitrary distance from a producing oil or gas well or on the basis of location on a geologic structure. Under section 13 of the MLLA, lands where the oil and gas potential was unknown (i.e., outside a "known geologic structure" or KGS) were to be made available under a noncompetitive prospecting permit, whereas section 17 provided that lands within the known geologic structure of a producing oil or gas field were to be leased by competitive bidding.⁴

Nowhere does the MLLA define the term "known geologic structure." The Department of the Interior (DOI) has the authority to determine KGS areas, but in *Arkla Exploration Co. v. Texas Oil & Gas Corp.*, the court found the procedure utilized by a Bureau of Land Management regional office to be

1. Act of Dec. 22, 1987, Pub. L. No. 100-203, 1988 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 1330.

2. Act of Feb. 11, 1897, ch. 216, 29 Stat. 526.

3. Act of Feb. 25, 1920, ch. 85, 41 Stat. 437 (codified at 30 U.S.C. §§ 181-287 (1982)).

4. Act of Feb. 25, 1920, §§ 13, 17, 41 Stat. 437, 441, 443.

arbitrary and an abuse of discretion.⁵ Forecasting the areal extent of producing oil and gas fields can be difficult even for the generator of the prospect and the operator of the wells and it proved even more difficult for a governmental agency. With the exception of the local practice in Arkansas described in the *Arkla* cases, the DOI has generally pursued a policy of defining a KGS area expansively. In recent years, however, many lessees complained that each KGS determination included too much acreage, thereby resulting in de facto competitive leasing of unproven public lands.

The prospecting permit concept for non-KGS leases was changed to an over-the-counter noncompetitive leasing system in 1935.⁶ In the early days, when a lease of lands outside a KGS expired or was relinquished by a lessee, a crowd of petroleum landmen often gathered at the federal office, and it was impossible for the DOI employees to know who should be favored for a new lease on the lands. There are many millions of acres of onshore federal lands and many thousands of leases are processed each year. The simultaneous drawing, or "lottery," was adopted in order to resolve the problems of fairness in choosing the next lessee of lands where an oil and gas lease had been allowed to expire by the previous lessee.⁷

2. The Federal Onshore Oil and Gas Leasing Reform Act of 1987

Early in 1987, Congress turned its attention to reforming the procedures for leasing onshore federal lands. Originally, it focused on perceived shortcomings in establishing known geologic structures in the competitive leasing system and on suggestions that more lands be subjected to competitive bidding. However, some members of Congress concluded that new environmental requirements should also be included in any legislation affecting onshore leasing. Thus, the principal focus in a Senate-passed bill was on enhanced competition in the leasing process. A bill passed by the House, however, imposed requirements that certain land use plans be developed prior to issuance of leases, and these plans were to be in addition to those required by existing legislation. In conference, these planning provisions were rejected, and the legislation which emerged speaks chiefly to increased competition in the leasing process.

The principal features of the Federal Onshore Oil and Gas Leasing Reform Act of 1987, as finally enacted, include:

—Provision for an initial all-competitive leasing system, with lease sales at least quarterly and minimum acceptable bids of \$2.00 per acre for the first two years after enactment. In the event no such bids are received, the lands may be leased noncompetitively during a period of two years upon payment of a statutory filing fee of seventy-five dollars. If not so leased during this time, they are again to become subject to competitive bidding. All bidding is to be oral.

—A requirement for non-objection by the Secretary of Agriculture prior to the

5. *Arkla Exploration Co. v. Texas Oil & Gas Corp.*, 734 F.2d 347 (8th Cir. 1984), *cert. denied*, 469 U.S. 1158 (1985).

6. Act of Aug. 21, 1935, ch. 599, 49 Stat. 674, 676 (amending 41 Stat. 437 (1920)).

7. Final Rulemaking, *Minerals Management and Oil and Gas Leasing; Revision of the Regulations Covering Oil and Gas Leasing on Federal Lands*, 48 Fed. Reg. 33,675 (1983) (codified at 43 C.F.R. Part 3110) (1987).

leasing of public domain National Forest lands. This is similar to the consent requirement presently in the Mineral Leasing Act for Acquired Lands⁸ and constitutes an additional restriction on mineral leasing on federal public lands. The Engle Act has required concurrence of the Secretary of Defense⁹ since 1958 to lease public lands withdrawn for military purposes.

—Increased rentals rising from \$1.00 per acre to \$1.50 per acre for the first five years and \$2.00 per acre thereafter.

—Royalties at not less than a 12.5% rate for competitive leases and at a fixed rate of 12.5% for noncompetitive leases.

—Provision for the Secretary of the Interior to disapprove assignments of less than 640 acres outside of Alaska and of less than 2560 acres in Alaska.

—Permanent (instead of annual) prohibitions on leasing in wilderness areas or wilderness study areas.

—Restrictions on granting new leases to anyone not reclaiming leased land after drilling.

—Certain savings provisions with respect to applications filed prior to the effective date of the legislation.

—Provision, in lieu of land use planning requirements, for studies to be conducted by the National Academy of Sciences and the Comptroller General of the manner in which oil and gas reserves in land use plans are developed in accordance with the Federal Land Policy and Management Act of 1976¹⁰ and the Forest and Rangeland Renewable Resources Planning Act of 1974.¹¹

—Remedies, penalties, fines and imprisonment for fraudulent practices.

During the coming months the DOI is expected to issue new regulations to implement the legislation.

B. Arctic National Wildlife Refuge Leasing

A major legislative struggle began taking shape over the management of the wildlife and energy resources of a portion of the coastal plain of the Arctic National Wildlife Refuge (ANWR), located on the North Slope of Alaska. On one side, the DOI, the oil industry, the State of Alaska, and Alaskan native corporations with land interests in the ANWR all argue that the development and production of the potentially vast ANWR oil reserves is vital to the long-term economic interests and energy security of the United States. On the other side, environmental and conservation groups plead that leaving the biological values of the unique arctic system intact at the ANWR outweigh the uncertain potential benefits of producing the reserves. This struggle has resulted in five bills being introduced for consideration by four congressional subcommittees.

1. History

In December 1980, Congress passed the Alaska National Interest Lands Conservation Act (ANILCA).¹² Section 1002 of the ANILCA required the DOI to report on, *inter alia*, the fish and wildlife resources and oil and gas potential of 1.5 million acres on ANWR's coastal plain ("1002 area"). The

8. 30 U.S.C. §§ 351-359 (1982).

9. 43 U.S.C. §§ 155, 158 (1982).

10. 43 U.S.C. §§ 1701-1784 (1982).

11. 16 U.S.C. §§ 1600-1687 (1982).

12. Pub. L. No. 96-487, 94 Stat. 2371 (codified at 16 U.S.C. §§ 3101-3233 (1982)).

ANILCA also authorized limited exploration in the 1002 area, but prevented any production without specific legislation by Congress. In March 1987, the DOI released its final report and recommendation to Congress, along with a legislative environmental impact statement in compliance with the directives of the ANILCA. In its report, the DOI recommended that Congress enact legislation making the entire 1002 area available for leasing and authorize the DOI to impose necessary and appropriate measures to protect the environment.

The DOI's assessment of the geological potential in the 1002 area is based on surface geological and geophysical exploration conducted by a private firm on behalf of fifteen oil companies. The U.S. Geological Survey and the Bureau of Land Management analyzed the data, and concluded that a nineteen percent probability exists that recoverable reserves will be discovered at the ANWR. The agency's mean estimates are 3.2 billion barrels of recoverable oil and 13.8 billion barrels of oil in place. The DOI identified twenty-six separate structures capable of containing large amounts of oil. In addition to the DOI's seismic survey, Chevron, Sohio, and British Petroleum drilled a test well on land within the 1002 area which is privately owned by the Kaktovik Inupiat Corporation. Although the results of the 1985 test well remain confidential, they have generated much speculation and enthusiasm.

Meanwhile, even before the DOI issued its report, environmental groups began to marshal congressional support to prevent development on the coastal plain. In June 1986, Rep. Morris Udall (D-Ariz.) introduced a bill to declare the 1002 area part of the federal wilderness system, thereby precluding exploration and development activities. The bill died at the expiration of the 99th Congress in December 1986, but Udall re-introduced an identical bill (H.R. 39) after the 100th Congress convened in January 1987, and it was referred to Udall's House Committee on Interior and Insular Affairs. Recently, Senator William Roth (R-Del.) introduced S. 1804, a companion bill to Udall's wilderness bill, and it was referred to the Senate Environment and Public Works Committee.

Since at least June 1986, the DOI has been negotiating with several Alaskan native corporations to exchange the subsurface rights in the 1002 area for extensive inholdings owned by these corporations on other federal lands. The DOI views these proposed exchanges as an unparalleled opportunity to obtain lands highly valued for their wildlife values. In July 1987, the DOI announced that it had reached agreements with the native corporations but that the deals were contingent upon congressional approval of a leasing program.

Two pro-development bills have been introduced: Rep. Don Young (R-Alaska) introduced H.R. 1082 in February 1987, and Sens. Ted Stevens and Frank Murkowski (R-Alaska) jointly introduced S. 1217. Of the two, the Senate bill has made further progress through its committee, the Senate Energy and Natural Resources Committee, chaired by J. Bennett Johnston (D-La.). This Committee has privately voted by a 2-1 margin to try to conclude work on development legislation by the end of the 100th Congress in December 1988.

Rep. Walter Jones (D-N.C.) and Rep. Robert Lindsay Thomas (D-Ga.), both on the House Merchant Marine and Fisheries Committee, jointly drafted what they consider a "compromise" bill, H.R. 3601 (the Jones bill). This bill would divide exploration and development into separate phases, protect certain acreage of the 1002 area considered to be especially sensitive and vital to the caribou population, and sharply regulate and limit the exploration process to four test wells. The Jones bill would require Congress to decide whether to allow production after considering the results yielded by these test wells.

2. Issues

Despite the large number of technical complexities present in the various proposals, debate has centered on three general policy questions: (1) How does the ANWR figure in America's comprehensive energy policy? (2) If development is authorized, what measures should be taken to insure compatibility with wildlife values? (3) Should the DOI be authorized to proceed with its agreements to trade the subsurface rights in the 1002 area to private native corporations?

a. Energy Policy

A comprehensive national energy policy, identifying the role of the ANWR, has become a threshold issue to many environmentalists as well as to key senators who have expressed reservations concerning the DOI's recommendations. Supporters of development had challenged environmentalists to discover equal sources of energy to meet America's national needs. Proponents of development emphasize the threat to national security posed by the nation's increasing dependence on oil imports. They note that Alaska's North Slope provides a large portion of our domestic production, and that the super-giant Prudhoe Bay field will start declining within the next few years. These conditions make it imperative that a new source of domestic oil be found, and ANWR is thought to be, by far, the most promising.

Environmentalists view this proposal as a "quick fix" solution to a long-term problem. They maintain that the entire volume of oil at the ANWR could be "produced" through conservation techniques. The Administration is faulted for urging the development of new oil sources but at the same time slashing research and development budgets for alternate fuel and conservation technologies and vetoing congressional legislation raising conservation standards.

b. Environmental Protection

The highest profile environmental issue concerns the treatment of a large section of the 1002 area which the Porcupine Caribou Herd (PCH) has shown a preference to use for calving purposes. This so-called "core-calving area" (the designation itself is vigorously debated) is estimated to contain approximately twenty-five percent of the recoverable reserves. The DOI and industry

officials believe that the "core-calving" area does not require special protection and recommend inclusion of these tracts in a general leasing program. Environmentalists believe that the "core-calving" area is vital to the survival of the migratory PCH and maintain that any drilling in this area would endanger the herd. The State of Alaska maintains that the issue requires more study and suggests that leasing in the designated "core-calving" area be deferred.

Other significant issues include the treatment of hazardous wastes, the use of water and gravel, and the emission of air pollutants. On all these issues, industry maintains that its record in previous North Slope projects demonstrates that it can produce oil in a manner compatible with wilderness values. Although environmentalists have challenged the industry record, Congress seems generally persuaded by the industry's case. The question then becomes what standard of protection to legislate and what level of technical investment to require of lessees.

c. Land Exchange

This issue has become perhaps the most divisive. It involves two questions: (1) Does the DOI have authority to exchange the subsurface rights for inholdings in other Wildlife Refuge System lands? (2) Would such exchanges be prudent, given the loss of federal royalties? Congress has asserted its authority over the disposal of the land; House and Senate bills to clarify this issue have been brought to the floor but have not yet been approved.

3. Future Prospects

In general, there has been little movement toward reconciliation of the views of the opposing parties. The one serious attempt at compromise, the Jones bill, has been rejected as unsatisfactory by both sides. Few observers are optimistic about resolving this division under election year conditions and most expect the struggle over the ANWR to carry well into 1989.

C. *Outer Continental Shelf (OCS) 5-Year Leasing Program*

At the end of April 1987, Secretary Hodel released the DOI's five-year offshore oil and gas leasing program, which covers the period from mid-1987 to mid-1992. The report provides for a total of thirty-eight lease sales over five years in twenty-one out of twenty-six OCS planning areas. The lease sales would occur in three stages: (1) twenty-four standard lease sales, including annual sales in the central and western Gulf of Mexico, and fourteen triennial sales in nine other planning areas; (2) eleven frontier exploration sales at a triennial or less frequent pace, with industry interest to be reassessed prior to the start of the standard presale process; and (3) three small supplemental sales of selective blocks (those in which bids were previously rejected or forfeited during the previous fiscal year, and development blocks susceptible to drainage). The report also defers a number of sub-areas from any lease sales during the five-year period.

Concerned primarily about possible adverse environmental effects from

OCS development, five coastal states (California, Oregon, Washington, Florida and Massachusetts) and an environmental coalition challenged the plan in a lawsuit filed in the United States Court of Appeals for the District of Columbia Circuit. That case is presently pending.¹³

II. ROYALTY VALUATION DEVELOPMENTS

During 1987, the DOI's Minerals Management Service (MMS) tackled two major royalty valuation initiatives. The first, retroactive modification of Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases—5 (NTL-5), involves efforts to resolve past gas valuation problems. The second, adoption of new oil and gas royalty valuation regulations, is an attempt to bring clarity, consistency and fairness to prospective royalty valuation. Before the year was over, Congress had played major roles in both rulemaking proceedings.

In addition to the NTL-5 and valuation regulation matters, the United States Court of Appeals for the Fifth Circuit heard oral argument in late 1987 on MMS' claim that it is entitled to royalties on millions of dollars of take-or-pay monies collected by gas producers from their pipeline purchasers.

A. NTL-5

1. Background

The NTL-5 was originally issued by the U.S. Geological Survey on May 4, 1977.¹⁴ Included in the NTL-5 was a provision that gas which was produced from Indian and onshore federal leases and which was subject to the Natural Gas Act be valued at the higher of the contract price received by the lessee or the applicable area or national rate prescribed by the Federal Power Commission. The following year, the Natural Gas Policy Act of 1978 (NGPA) was enacted, and, to the extent that the NTL-5 was subsequently followed, the NGPA ceiling prices were deemed to supersede the area and national rates referenced in the NTL-5.

For the next several years, most lessees, as well as the DOI, paid little attention to the NTL-5. At a time when the demand for gas outstripped the supply, most producers were able to charge and collect the NGPA ceiling prices and most paid royalties on the ceiling prices, since ceiling prices were the bases on which they were paid for their gas.

Beginning in the early 1980s, many producers were no longer able to collect ceiling prices due to a softening gas market. However, most producers apparently continued to pay royalties on the basis of the prices received for gas, rather than on any higher applicable maximum lawful price. Moreover, the MMS generally seemed unconcerned with the lack of compliance with the NTL-5, and many top MMS officials routinely provided lessees with assurances that the payment of royalties on the basis of prices received under arm's-length contracts would satisfy their royalty obligations.

13. *Natural Resources Defense Council v. FERC*, No. 87-1432 (D.C. Cir. filed Aug. 27, 1987).

14. *Final Notice to Lessees and Operators*, 42 Fed. Reg. 22,610 (1977).

Then, in *Union Oil Co.*,¹⁵ the MMS issued a decision which held, inter alia, that the NTL-5 was a binding regulation. (At least one court has, however, determined that the NTL-5 is not a binding regulation.¹⁶) Six weeks after issuance of the *Union Oil* decision, the MMS issued a proposal to delete, prospectively, the requirement that royalties be paid on the NGPA ceiling prices if those prices exceed contract prices.¹⁷ Recognizing that gas sales prices had been below the NGPA ceiling prices for some time, the agency further suggested making such an amendment retroactive to March 1984. However, following receipt of written comments, the DOI, on July 25, issued its "Notice of Modification to Notice to Lessees—5" which deleted only prospectively the NTL-5's use of the NGPA ceiling prices.¹⁸

2. 1987 Developments

On January 15, 1987, less than six months after the July 25 modification, the MMS issued a "Notice of Proposed Modification to Notice to Lessees-5" in which it suggested retroactively deleting, to as far back as May 1, 1982, the requirement that royalties be paid on ceiling prices which exceed contract prices.¹⁹ (May 1, 1982, was the date of the first exercise of market-out clauses by a major interstate pipeline.) At the time it issued the January 15 proposal, the NTL-5 issue had become an emotional one for many parties with an interest in the issue: producers, Indians, and states which receive a share of royalties collected from federal leases within their bounds. All were scrambling to preserve their share of a diminishing gas revenue pie. The emotionalism was exacerbated because the approximate economic impact of any retroactive modification of the NTL-5 was unknown. The MMS issued several different financial estimates, and the recipients of royalties collected by the DOI (i.e., states and Indians) issued their own impact analyses.

Then, in the spring of 1987, Congress became involved in the NTL-5 debate when a rider was attached to the 1987 supplemental appropriations bill to prohibit any amendments to the NTL-5 until November 1, 1987.²⁰ Subsequently, subcommittees of the Senate Committee on Energy and Natural Resources and the House Committee on Interior and Insular Affairs held hearings on the NTL-5 issue. In addition, governors of several western states, which receive a large portion of the onshore royalties collected by the MMS, intervened in an attempt to fashion a compromise. Among the key issues to be resolved was the matter of who would bear the burden of making any refunds (to those producers who had continued to value their gas at the NGPA ceiling prices) if the NTL-5 were modified retroactively—Indians, the states, or only the federal treasury? After the non-legislative participants were unable to

15. *Union Oil Co.*, Nos. MMS-85-0085-O&G, MMS-84-0020-O&G (DOI Nov. 27, 1985).

16. *Shoshone Indian Tribe v. Hodel*, No. C81-131-K (D. Wyo. Jan. 7, 1987) (order on reconsideration).

17. Notice of Proposed Modification to Notice to Lessees-5, 51 Fed. Reg. 260 (1986).

18. Notice of Modification to Notice to Lessees-5, 51 Fed. Reg. 26,759 (1986).

19. Notice of Proposed Modification to Notice to Lessees-5, 52 Fed. Reg. 1671 (1987).

20. Supplemental Appropriations Act, 1987, Pub. L. No. 100-71, ch. VI, 1987 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 391, 415-16.

effectuate a final compromise, Congress enacted, in the waning days of its 1987 session, H.R. 3479, which retroactively modifies the NTL-5 for the period January 1, 1982 through July 31, 1986.²¹

Pursuant to the act, lessees are relieved of the burden of paying gas royalties on the basis of unobtainable NGPA ceiling prices and can apply to the MMS for a refund of the amounts by which royalties previously paid on the basis of ceiling prices exceeded royalties which would have been paid pursuant to the royalty valuation standards set out in the act (which standards are similar to those contained at 30 C.F.R. § 206.103 (1987)). For this latter purpose, Congress has authorized the expenditure of two million dollars to cover the federal and Indian shares of any repayments owed to producers. Prior to obtaining refunds, however, producers are subject to having their royalty payments audited for the period for which refunds are requested.

Regulations governing the procedures for seeking refunds are to be prescribed by the MMS in 1988.

B. New Oil and Gas Royalty Valuation Regulations

1. Background

Practically since its creation in 1982, the MMS has been working toward promulgation of new royalty valuation and allowance regulations. At the beginning of this effort, the MMS contemplated the issuance of "guidelines" to advise lessees on how to determine royalty values and how to calculate deductions for transporting and processing production. Subsequently, the MMS was persuaded that the preferable course of action was a rulemaking proceeding leading to the issuance of regulations that could be included in the Code of Federal Regulations to replace the existing regulations.²²

In 1986, the MMS launched its rulemaking efforts in earnest by making available advance notices of proposed rulemaking governing coal, oil and gas.²³ The MMS held public hearings and received written comments on the advance notices. Subsequently, the Secretary of the Interior's Royalty Management Advisory Committee (RMAC), which had been created to advise the Secretary on royalty management matters in general, requested and was given permission to review the advance notices of proposed rulemaking and to comment on them. The RMAC created separate work panels to consider oil, gas and coal valuation regulations, but the RMAC was unable to adopt officially any of the reports forwarded to it by its work panels because of substantive disagreements among the RMAC membership.

During 1986, Congress became interested in the development of new valuation regulations and encouraged the MMS to advance the rulemaking process. Thus, in the conference report²⁴ accompanying the 1987 continuing

21. Notice to Lessees No. 5 Gas Royalty Act of 1987, Pub. L. No. 100-234, 101 Stat. 1719, 1720.

22. The existing regulations for oil and gas are generally contained in 30 C.F.R. Part 206, and 25 C.F.R. Parts 211 and 212, though other provisions in the Code of Federal Regulations also impact the amount of royalties payable and the procedures for paying royalties. *See, e.g.*, 30 C.F.R. Parts 202 and 203 (1987).

23. 51 Fed. Reg. 4507, 7811 (1986).

24. H.R. REP. No. 99-1005, 99th Cong., 2d Sess. 701 (1986).

appropriations bill for the DOI and other agencies,²⁵ the MMS was instructed to issue notices of proposed rulemaking for new coal, oil, and gas royalty valuation regulations early in 1987. The MMS complied with the instructions of the conferees by issuing notices of proposed rulemaking for coal and oil regulations on January 15, 1987,²⁶ and for gas on February 13, 1987.²⁷

Then Congress became more deeply involved in the rulemaking process. Concerned with various procedural and substantive aspects of the rulemakings, Congress included in the 1987 supplemental appropriations bill a provision which prohibited the MMS from amending its product valuation regulations until November 1, 1987.²⁸ (This same language also prohibited the MMS from retroactively modifying the NTL-5, *supra*). Subsequently, as part of the fiscal year 1988 DOI appropriations bill, the House Appropriations Committee included language prohibiting the DOI from implementing new regulations (or modifying the NTL-5) at any point during fiscal year 1988. Like the MMS' January 15, 1987 proposal to modify retroactively the NTL-5,²⁹ the MMS' proposals to adopt prospective royalty valuation regulations became the subject of congressional hearings.

Also like the case of the NTL-5, the controversy surrounding the new product valuation regulations was largely focused on economic impacts. Beginning with publication of the advance notices of proposed rulemaking in 1986,³⁰ the MMS had issued several economic impact analyses of its proposed regulations, and these impact analyses varied dramatically. Thus, Congress was concerned with a potential loss of federal revenues if lessees were permitted to pay fewer royalties under new regulations than under the existing regulations.

Moreover, many states and Indian groups, fearing loss of royalty income, attacked the principle basis of the proposed regulations: the concept that royalties should be paid on the basis of prices received under arm's-length contracts between lessees and the purchasers of production. Some argued that arm's-length contracts do not really reflect the "true" value of production, while others argued that there are no real arm's-length contracts for the sale of production, especially for the sale of gas.

Thus, many states and Indian groups asserted that other indicia of value should be included in the royalty valuation regulations. Some suggested that all production be valued at the highest price received for any production sold from the field, some argued that the value of oil production ought to be based on the value of refined products less the costs of refining and transporting production to the refinery, while others argued that the MMS should set minimum values on a field-by-field or area-by-area basis.

25. Continuing Appropriations for Fiscal Year 1987, Pub. L. No. 99-500, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 1783.

26. 52 Fed. Reg. 1840, 1858 (1987) (pertaining to coal and oil, respectively).

27. 52 Fed. Reg. 4732 (1987).

28. Supplemental Appropriations Act, 1987, Pub. L. No. 100-71, ch. VI, 1987 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 391, 415-16.

29. 52 Fed. Reg. 1671 (1987).

30. 51 Fed. Reg. 4507, 7811 (1986).

Oil and gas producers, for their part, also found much to criticize in the proposed regulations, particularly the provisions governing processing and transportation allowances. In addition, coal producers raised issues unique to their industry. Eventually the DOI decided to put adoption of new coal royalty valuation regulations on a different timetable than that of the oil and gas valuation regulations.³¹

During the summer of 1987, meetings were held among various interested participants (Indians, states, producers, the DOI, and congressional staff members) in an attempt to resolve the substantive differences among the parties. Largely as a result of these informal discussions, the MMS issued further notices of proposed rulemaking on August 17, 1987.³² Following the receipt of comments on the August 17 proposals, further informal discussions were held among participants, which led to publication of second further notices of proposed rulemaking on October 13, 1987.³³ Finally, on January 15, 1988, the MMS issued final valuation and allowance rules for oil and gas.³⁴

2. Outline of the Valuation Regulations

In the new regulations, the MMS starts with the principle that the best indication of the value of production is the price received by a lessee for the sale of production pursuant to the terms of an arm's-length contract. Thus, where production is sold under an arm's-length contract, the gross proceeds received for the sale of that production are utilized to value the production. Obviously, a lessee must first determine whether his contract falls within the definition of "arm's-length contract," a key term in the new regulations. The burden of demonstrating that a contract is at arm's-length is always on the lessee. If the contract is at "arm's-length," then the lessee must calculate his "gross proceeds." In drafting a definition of gross proceeds, the MMS has included all conceivable monies received by an oil and gas producer, some of which, producers have argued, are not obtained for the sale of production and are, therefore, not burdened by a royalty obligation. (Take-or-pay monies will be discussed further, *infra*).

If the production is not sold under an arm's-length contract, then it is to be valued for royalty purposes in accordance with the first applicable benchmark on a list of prioritized benchmarks. Given the differences in the marketing of oil and gas, the benchmarks prescribed for oil and gas also vary. Both valuation rules, however, prohibit royalty values from ever falling below the gross proceeds received by the lessee.

Other key aspects of the new rules include provisions governing the calculation of deductible allowances for processing gas and transporting oil and gas from a lease to a downstream point of disposition. In the case of arm's-length transportation and processing contracts, the lessee may simply deduct the costs of such services. However, where processing or transportation is not performed under arm's-length contracts, then, with some exceptions, the

31. 52 Fed. Reg. 43,919 (1987).

32. 52 Fed. Reg. 30,776, 30,826 (1987).

33. 52 Fed. Reg. 39,792, 39,846 (1987).

34. 53 Fed. Reg. 1184, 1230 (1988).

lessee must resort to detailed cost-accounting procedures to calculate allowable deductions. Processing allowances are generally limited to 66 $\frac{2}{3}$ % of the value of gas plant products, while transportation allowances may not exceed fifty percent of the value of the product without permission from the MMS.

Finally, the MMS has made these regulations generally self-implementing: prior approval is not required for a lessee before he ascribes a value to his oil or gas for royalty purposes or before he deducts a transportation or processing allowance, though certain reporting requirements must be met. Of course, all valuations and allowances claimed by producers are subject to audit by the MMS.

C. *Take-or-Pay Royalty Litigation*

In recent years, the DOI has sought to require lessees to pay royalties on take-or-pay prepayments under gas sales contracts, notwithstanding the lessees' vigorous opposition. This running battle has now moved to the United States Court of Appeals for the Fifth Circuit as a result of conflicting decisions by two Louisiana federal district courts.

In *Mesa Petroleum Co. v. DOI*,³⁵ the DOI lost on its claim to share in its lessee's take-or-pay monies. The court relied on case law to determine that "[b]ecause a royalty interest is a right to share in production if and when production is obtained . . . an owner of a royalty interest is entitled to royalties only to the extent of that production"³⁶ and then concluded that "production" refers to oil and gas "actually severed from the ground."³⁷

Based on its analysis that royalties are due only to the extent of production and that production refers to oil and gas actually severed from the ground, the court concluded that when a pipeline purchaser "makes take-or-pay payments, it does so *in lieu of* taking production, and the minerals remain in the ground. To the extent [the purchaser] makes take-or-pay payments, there is no production; therefore, the DOI is not authorized by [the Outer Continental Shelf Lands Act (OCSLA)] to collect royalties on take-or-pay payments."³⁸

In finding for the lessee, the *Mesa* court rejected the DOI's argument that royalties were due not on production, but rather on the "value of production" and that take-or-pay payments are part of the gross proceeds received for the disposition of the produced substances and, hence, part of the "value of production" as that term is used in 30 C.F.R. § 206.150. The court viewed the DOI's argument as an erroneous application and unduly narrow interpretation of § 206.150.³⁹

Just over two months after the *Mesa* decision was issued, the United States District Court for the Eastern District of Louisiana issued a contrary

35. *Mesa Petroleum Co. v. DOI*, 647 F. Supp. 1350 (W.D. La. 1986), *appeal docketed*, No. 87-4069 (5th Cir. 1987).

36. *Id.* at 1354.

37. *Id.* (quoting *Energy Oils, Inc. v. Montana Power Co.*, 626 F.2d 731, 738 (9th Cir. 1980)).

38. *Id.* (citing OCSLA, 43 U.S.C. §§ 1331-1356 (1982)) (emphasis in original).

39. *Id.* at 1355.

decision in *Diamond Shamrock Exploration Co. v. Hodel*.⁴⁰ *Diamond Shamrock*, unlike *Mesa*, involved both OCSLA leases and onshore federal leases.

With respect to the OCSLA leases, the court cited 30 C.F.R. § 206.150's treatment of the "value of production." The governing MLLA regulation, said the court, is 30 C.F.R. § 206.103, which provides, inter alia, that "[u]nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof." Agreeing with the DOI that take-or-pay revenues are part of the total consideration for the purchase and sale of gas under the contract, the district court concluded that under the OCSLA, the MLLA, and the governing regulations, take-or-pay payments are part of the gross proceeds from the disposition of gas on which lessees are required to pay royalties.⁴¹

In rejecting the producers' argument that take-or-pay payments are not payments for gas (unless and until make-up gas has been taken) but are instead intended to compensate producers for ongoing capital and operational costs which they incur regardless of whether the purchaser takes gas, the court stated:

The distinction the companies suggest offends common sense. The market value of gas includes some amount that is attributable only to the physical gas itself. The value of gas also includes some amount for all the activities conducted by the gas company in bringing that gas out of the ground and to the market. Royalty is payable on all the normal components of the value, regardless of the ability of the buyer and seller to separate by contract into discreet payments various components of the value of gas sold.⁴²

A contrary holding, thought the court, would provide lessees with incentives to avoid royalty obligations through clever draftmanship by identifying payments which are in fact consideration for the purchase of gas as payments for something else.⁴³

Both *Mesa* and *Diamond Shamrock* were appealed to the Fifth Circuit, where they were consolidated. Oral argument was held on December 8, 1987.

George H. Rothschild, Jr., *Chairman*
Ernest C. Baynard, III, *Vice Chairman*

Jennifer A. Cates
James M. Day
James M. Dunnam
Michael L. Grove
Douglas K. Kerner
John Lamont
Martin Lobel
Jerome C. Muys

Stephen F. Noser
William Perry Pendley
Edgar F. Rummel
John L. Sachs
Paul Strohl
John J. Tonnsen
Edward J. Twomey
Lowell E. Williams

40. *Diamond Shamrock Exploration Co. v. Hodel*, No. 86-537 (E.D. La. Jan. 23, 1987), *appeal docketed*, No. 87-3195 (5th Cir. 1987).

41. *Diamond Shamrock*, No. 86-537, slip op. at 9-10 (E.D. La. Jan. 23, 1987).

42. *Id.* at 10.

43. *Id.* at 10 n.2.

